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November 22, 2010

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
RE: Docket No. R-1366

Dear Ms. Johnson:

Wolters Kluwer Financial Services (WKFS) is providing this comment letter in response to the Interim Rule published by the Federal Reserve Board on September 24, 2010 in the Federal Register. The Interim Rule is an amendment to Regulation Z and was issued in response to the Mortgage Disclosure Improvement Act (MDIA) that amended the Truth in Lending Act. MDIA seeks to ensure that mortgage borrowers are alerted to the risks of payment increases.

WKFS is a provider of compliance products to the financial services industry. Among the products we support are Truth in Lending disclosure documents and software systems that produce the documents and calculations necessary to support a mortgage transaction. Providing accurate Truth in Lending disclosures is a cornerstone of our product offerings; therefore WKFS has been reviewing the Interim Rule in order to provide the necessary updates to our products.

Among our products are loan origination systems that are sold in the community bank market. The community bank market supports a wide variety of mortgage loan products in order to meet the needs of the mortgage borrowers in their communities. While the Interim Rule provides guidance on the more common mortgage transactions, there is a lack of guidance for some of the mortgage transactions currently supported in the community bank market. Due to the current economic and regulatory environment, WKFS believes that we cannot support some of these traditional products in our software systems until such time as specific written guidance is available. The purpose of this letter is to identify these mortgage transactions and to request that guidance be provided within Regulation Z or the Official Staff Commentary. By providing this written guidance, the entire industry (creditors, examiners, lawyers, providers of compliance products, etc.) will have a common understanding of the requirements in order to better serve the mortgage borrower.

We are requesting written guidance on the proper disclosure of the following transactions under MDIA and Regulation Z:

**1. Adjustable rate mortgages in which an increase in the interest rate will result in an increase in the loan term**. Adjustable rate mortgages are common in the marketplace. However, not all adjustable rate mortgage products will increase the amount of the monthly payment when the interest rate rises, some mortgage products would increase the *term of the loan*. The lender might choose a mortgage product like this when there is a desire for an adjustable rate product, but there remains an interest in keeping the monthly payments the same to meet the budget needs of the mortgage borrower. In an environment of rising interest rates, the loan term would get extended. In an environment of falling interest rates, the loan term would shorten. Since the purpose of MDIA is to ensure the mortgage borrowers are alerted to the risks of payment increases, it follows that with this loan product, the mortgage borrowers will need an understanding of the risk of the *number* of payments increasing.

Model form H-4(F) was designed to provide information to the mortgage borrower regarding the risks of payment increases for an adjustable rate mortgage. However, this model form was designed on the assumption that the monthly payments would be increasing. H-4(F), by itself, does not explain the risks to the mortgage borrower when the increase in the interest rate results in an increase in the term of the loan.

Model form H-4(H) was designed to provide information to the mortgage borrower in situations in which negative amortization could arise. Depending upon the criteria used by the lender, negative amortization could arise for loans in which the increase in interest rate results in an increase in the term of the loan. However, this model form seems to be specifically designed for a specific type of adjustable rate mortgage known as “payment options ARMs” that include full payment options and minimum payment options. These options are not a part of this transaction type being discussed; therefore this model form is not helpful in disclosing the risk of interest rate increases to the mortgage borrower.

We would suggest that Regulation Z and the model form H-4(F) be enhanced for this mortgage product. We would suggest that a sentence be added below the INTEREST RATE AND PAYMENT SUMMARY table to alert the mortgage borrower to the “worst case scenario” in terms of the lengthening of its loan term under the legal obligation. We suggest language similar to the following: “An increase in the interest rate will cause an increase in the number of payments. If interest rates rise as rapidly as possible under the terms of this mortgage, your loan term would increase to a maximum of (maximum loan term).”

We would also suggest that if negative amortization is a possibility under the terms of the loan, the following statement should appear under the INTEREST RATE AND PAYMENT SUMMARY table: “Negative amortization. If any of your payments is not sufficient to cover the interest due, the difference will be added to your loan amount. Your loan balance can rise to a maximum of $(maximum loan balance).”

With regard to the “maximum loan balance” mentioned in the paragraph above, it is appropriate to note that a similar disclosure is found within the Good Faith Estimate (GFE) required under the Real Estate Settlement Procedures Act and Regulation X. In the “Summary of your loan” section of the GFE, the lender must disclose the maximum amount to which the loan balance may rise in a transaction that has negative amortization. We believe it is useful to the mortgage borrower to be disclosing consistent (rather than conflicting) information between the GFE and the Truth in Lending disclosure.

**2. Adjustable rate mortgages in which an increase in the interest rate will result in an increase in the final payment.** As mentioned previously, adjustable rate mortgages are common in the marketplace. However, not all adjustable rate mortgage products will increase the amount of the monthly payment when the interest rate rises, some mortgage products would increase the *amount of the final payment*. The lender might choose a mortgage product like this when there is a desire for an adjustable rate product, but there remains an interest in keeping the monthly payments the same to meet the budget needs of the mortgage borrower. In an environment of rising interest rates, the amount of the final payment would get larger, resulting in a balloon payment – potentially a very large balloon payment. Since the purpose of MDIA is to ensure the mortgage borrowers are alerted to the risks of payment increases, it follows that with this loan product, the mortgage borrowers will need an understanding of the risk of the *final payment increasing* and perhaps becoming a large balloon payment.

Model form H-4(F) was designed to provide information to the mortgage borrower regarding the risks of payment increases for an adjustable rate mortgage. However, this model form was designed on the assumption that the monthly payments would be increasing. H-4(F), by itself, does not explain the risks to the mortgage borrower when the increase in the interest rate results solely in an increase to the final payment amount. While the Interim Rule does include model language for balloon loans, that language anticipates a balloon amount that is known at the time of closing, not a balloon amount that could increase substantially in an environment of rapidly rising interest rates.

Model form H-4(H) was designed to provide information to the mortgage borrower in situations in which negative amortization could arise. Depending upon the criteria used by the lender, negative amortization could arise for loans in which the increase in interest rate results in an increase in the amount of the final payment. However, this model form seems to be specifically designed for a specific type of adjustable rate mortgage known as "payment options ARMs" that include full payment options and minimum payment options. These options are not a part of this transaction type being discussed; therefore this model form is not helpful in disclosing the risk of interest rate increases to the mortgage borrower.

We would suggest that Regulation Z and the model form H-4(F) be enhanced for this mortgage product. We would suggest that a sentence be added below the INTEREST RATE AND PAYMENT SUMMARY table to alert the mortgage borrower to the "worst case scenario" in terms of the increase to the final payment under the legal obligation. We suggest language similar to the following: "An increase in the interest rate will cause an increase in the amount of the final payment. If interest rates rise as rapidly as possible under the terms of this mortgage, your final payment could increase to a maximum of $ (maximum final payment amount)."

We would also suggest that if negative amortization is a possibility under the terms of the loan, the following statement should appear under the INTEREST RATE AND PAYMENT SUMMARY table: "Negative amortization. If any of your payments is not sufficient to cover the interest due, the difference will be added to your loan amount. Your loan balance can rise to a maximum of $(maximum loan balance)."
As mentioned in Section 1 (above), disclosure of the "maximum loan balance" is also mirrored in the GFE disclosures.

**3. Principal reduction loans.** A principal reduction loan is one in which the interest payment stream has been defined separately from the principal payment stream for the entire term of the loan. An example might be a loan in which interest on the outstanding balance is paid monthly along with a defined amount of principal (e.g., $1000). The principal payment remains at $1000 for the life of the loan. In a fixed rate transaction, the amount of the interest payment decreases over time, as the principal balance is paid down.

The current requirements under 226.18(g) for the payment schedule are flexible enough to support this type of transaction and provide useful information to the mortgage borrower. However, the new requirements from the Interim Rule under 226.18(s) do not anticipate this type of loan and do not offer the flexibility needed to properly disclose it.

We would suggest that Regulation Z be enhanced to support this mortgage product, including the creation of a variation of model form H-4(H). Below is an example of H-4(H) for a fixed rate principal reduction loan. The principal payments and interest payments would be disclosed on separate rows. Additional explanatory text would appear below the table, as follows:

INTEREST RATE AND PAYMENT SUMMARY

| | Rate and Monthly Payment |
|---|---|
| Interest Rate | % |
| Principal Payment | $ |
| Interest Payment | $ |
| Estimated Taxes + Insurance (Escrow)<br>• Includes [Private] Mortgage Insurance | $ |
| Total Estimate Payment | $ |

Principal payments will remain constant over the term of the loan. Interest payments will decrease over time as the loan balance is paid down.

We would suggest something like this for a variable rate principal reduction loan. The interest payment will vary with changes to the interest rate; the principal payment remains constant:

INTEREST RATE AND PAYMENT SUMMARY

| | Rate and Monthly Payment | MAXIMUM during FIRST FIVE YEARS (date) | MAXIMUM EVER (as early as) |
|---|---|---|---|
| Interest Rate | % | % | % |
| Principal Payment | $ | $ | $ |
| Interest Payment | $ | $ | $ |
| Estimated Taxes + Insurance (Escrow)<br>• Includes [Private] Mortgage Insurance | $ | $ | $ |
| Total Estimate Payment | $ | $ | $ |

Principal payments will remain constant over the term of the loan. Interest payments will vary over time based upon the interest rate in effect from time to time and the amount of the outstanding loan balance.

**4. Irregular payment.** Irregular payment loan are loans in which the timing of the payments is adjusted to account for the seasonal income of the mortgage borrower. This type of loan is also known as a “skip payment” loan or even perhaps a “teacher loan.” An example of this type of loan is when payments are scheduled for the months of September through May, with no payments scheduled for June through August.

The current requirements under 226.18(g) for the payment schedule are flexible enough to support this type of transaction and provide useful information to the mortgage borrower regarding the months for which payment is required. However, the new requirements from the Interim Rule under 226.18(s) do not anticipate this type of loan and do not offer the flexibility needed to properly disclose it.

We would suggest that Regulation Z be enhanced to recognize these types of loans. In addition to the appropriate INTEREST RATE AND PAYMENT SUMMARY table, text such as the following could appear below the table: “Payments will be made monthly, except for the months of (insert the months in which payment will not be made).”

**5. Loan types for which negative amortization is a possibility.** The Interim Rule created model form H-4(G). This model form seems designed to meet the needs of a product in the market place known as “payment option ARMs.” Payment option ARMs allow the mortgage borrower to pick between several payment options each month – including, for example, an interest-only payment, an amortizing payment, or a non-amortizing payment. This model form specifically discloses a “full payment” option as well as a “minimum payment option.” Unfortunately, this table does not work well beyond the “payment option ARMs.” Other types of loan for which negative amortization include loans with payments caps, or the loans described in items 1 and 2 above.

We would like to suggest that for negative amortization loans beyond “payment options ARMs” that Regulation Z be enhanced to require an appropriate variation of model form H-4(F) that would include the following language below the INTEREST RATE AND PAYMENT SUMMARY table that would alert the mortgage borrower to the risk of negative amortization: “Negative amortization. If any of your payments is not sufficient to cover the interest due, the difference will be added to your loan amount. Your loan balance can rise to a maximum of $(maximum loan balance).”

**6. Two-phase loans in which the payment frequencies differ between the two phases.** Some loan products have variations in the frequency of payments. Here are some examples:

- A construction\permanent loan, disclosed as a single transaction, in which, for example, the interest is paid monthly during the interest-only phase, and the principal + interest payment may be paid quarterly during the permanent financing phase.
- A principal reduction loan (see #3 above) in which, for example, the interest payments are made monthly and the defined principal amount is paid quarterly.

The current requirements under 226.18(g) for the payment schedule are flexible enough to support this type of transaction and provide useful information to the mortgage borrower regarding the frequencies and amounts of the payments required. However, the new requirements from the Interim Rule under 226.18(s) do not anticipate this type of loan and do not offer the flexibility needed to properly disclose it.

We would suggest a variation of H-4(H) be used, with additional bullet points used to describe the frequency of the principal payments and the frequency of the interest payments. The "Total Estimated Payment" would be the combined principal payment and interest payment. In the example below, the "Total Estimated Payment" would be labeled as the "Total Estimated Quarterly Payment," as that represents the frequency of the combined payment and represents the higher amount to be paid.

We would suggest the following information for a fixed rate, principal reduction transaction in which interest payments and principal payments have a different frequency. In this example, interest is paid monthly while principal is paid quarterly.

INTEREST RATE AND PAYMENT SUMMARY

| | Rate and Payment |
|---|---|
| Interest Rate | % |
| Principal Payment<br>• Paid quarterly | $ |
| Interest Payment<br>• Paid monthly | $ |
| Estimated Taxes + Insurance (Escrow)<br>• Includes [Private] Mortgage Insurance | $ |
| Total Estimated Quarterly Payment | $ |

We would suggest the following information for a variable rate, principal reduction transaction in which interest payments and principal payments have a different frequency. In this example, interest is paid monthly while principal is paid quarterly.

INTEREST RATE AND PAYMENT SUMMARY

| | Rate and Quarterly Payment | MAXIMUM during FIRST FIVE YEARS (date) | MAXIMUM EVER (as early as) |
|---|---|---|---|
| Interest Rate | % | % | % |
| Principal Payment<br>• Paid quarterly | $ | $ | $ |
| Interest Payment<br>• Paid monthly | $ | $ | $ |
| Estimated Taxes + Insurance (Escrow)<br>• Includes [Private] Mortgage Insurance | $ | $ | $ |
| Total Estimate Quarterly Payment | $ | $ | $ |

WKFS appreciates the effort from the Federal Reserve Board in crafting this Interim Rule. We are hopeful that the Board will consider the necessary enhancements to the Interim Rule, as described above, in order to meet the needs of the industry and mortgage borrowers alike.

Sincerely,

Jeanne Peterson Erickson
Senior Attorney, Compliance Services

JPE/dlm